

ORIGINAL

Before The  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554

100-100000

JUL 1 - 1992

In the Matter of

Treatment of Local Exchange Carrier  
Tariffs Implementing Statement of  
Financial Accounting Standards,  
"Employers Accounting for Post-  
retirement Benefits Other Than Pensions"

Bell Atlantic Tariff F.C.C. No. 1

US West Communications, Inc. Tariff  
F.C.C. Nos. 1 and 4

Pacific Bell Tariff F.C.C. No. 128

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) CC Docket No. 92-101  
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) Transmittal No. 497  
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) Transmittal No. 246  
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) Transmittal No. 1579

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OPPOSITION OF THE  
AD HOC TELECOMMUNICATIONS  
USERS COMMITTEE TO DIRECT CASES

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AD HOC TELECOMMUNICATIONS  
USERS COMMITTEE

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### SUMMARY

The Commission instituted this investigation principally to determine whether exogenous treatment of costs attributable to the implementation of SFAS-106 is warranted and necessary under its price cap rules and policies. In order to secure exogenous cost treatment, it is incumbent upon LECs to demonstrate that implementation of SFAS-106 will result in exogenous cost changes recognizable under the Commission's price cap rules and policies. The Ad Hoc Committee submits that the carriers have failed altogether to satisfy this heavy burden.

The carriers justify their requests for exogenous cost treatment of SFAS-106-related costs by claiming that the vast preponderance of such costs will not be adequately captured by the GNP-PI. In support of this contention, the carriers rely principally on studies conducted by Godwins, Inc. and National Economic Research Associates, Inc. The methodologies and assumptions underlying these analyses, however, are seriously flawed. These studies, accordingly, fail to demonstrate that the exogenous cost treatment the carriers seek would not result in the double counting of costs.

Denial of exogenous treatment of costs associated with the implementation of SFAS-106, however, need not rest on this solitary ground. Exogenous cost treatment of such costs is inconsistent with, and indeed conflicts with, critical Commission price cap policy objectives. The Commission has repeatedly denied exogenous cost treatment where such policy conflicts are present.

The Ad Hoc Committee, accordingly, urges the Common Carrier Bureau to reject the captioned tariff transmittals, and to decline to treat SFAS-106-related costs as exogenous for price cap purposes.

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Federal Communications Commission  
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	)	
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OPPOSITION OF THE  
AD HOC TELECOMMUNICATIONS  
USERS COMMITTEE TO DIRECT CASES

The Ad Hoc Telecommunications Users Committee ("Ad Hoc Committee" or "Committee"), in accordance with Common Carrier Bureau ("Bureau") Order of Investigation and Suspension, DA 92-540, 7 FCC Rcd. 2724, released April 30, 1992 ("Designation Order"), hereby opposes the "Direct Cases" filed in the captioned proceeding by the Ameritech Operating Companies ("Ameritech"), the Bell Atlantic Telephone Companies ("Bell Atlantic"), BellSouth Telecommunications, Inc. ("BellSouth"), the GTE Telephone Operating Companies ("GTOC"), the NYNEX Telephone Companies ("NYNEX"), Pacific Bell and Nevada Bell, the Rochester Telephone Corporation ("Rochester"), Southern New England Telephone Company ("SNET"), Southwestern Bell Telephone Company ("Southwestern Bell"), US West Communications, Inc. ("US West"), and the United Telephone Companies ("United") (collectively the "Price Cap Carriers"). In

their Direct Cases, the Price Cap Carriers argue unanimously for exogenous treatment of certain cost increases attributable to the implementation of the Statement of Financial Accounting Standards - 106 ("SFAS-106"), "Employers Accounting for Postretirement Benefits Other Than Pensions" ("OPEB"). The Ad Hoc Committee urges the Bureau to reject these overtures. As the Committee will show below, the Price Cap Carriers have failed altogether to satisfy their burden of establishing that the implementation of the SFAS-106 accounting changes will result in exogenous cost changes recognizable under the Commission's price cap rules and policies.

I.

**INTRODUCTION**

On April 30, 1992, the Bureau suspended and initiated an investigation of tariff revisions by which Bell Atlantic, Pacific Bell and US West proposed to increase their respective price cap index ("PCI") levels to account for cost increases purportedly attributable to the implementation of SFAS-106. The proposed PCI adjustments were a direct product of the carriers' claim that SFAS-106-related costs are properly categorized as exogenous within the Commission's price cap regulatory regime. Underlying the Bureau's suspension and investigation of these tariff revisions were doubts regarding the sufficiency of the carriers' showings that exogenous cost treatment of costs associated with the implementation of SFAS-106 was consistent with the Commission's price cap rules and policies, as well as a recognition that the complexity of the

econometric issues implicated by the carriers' proposals required intense analysis and full participation by interested parties.

To facilitate a thorough review of these matters, the Bureau designated a series of issues for investigation. The designated issues include the threshold question of the proper price cap classification of the costs of implementing SFAS-106, as well as multiple inquiries addressing the studies upon which the carriers predicate their claimed need for PCI increases. The Bureau also directed each of the Price Cap Carriers to submit additional data and information regarding its implementation of SFAS-106, the level and allocation of costs associated therewith, its OPEB benefits and the manner in which such benefits are currently costed, accounted for and funded, and the models and methodologies, including assumptions and inputs, used by the carriers in computing SFAS-106 expenses. And critically, the Bureau invited interested parties to comment on the Price Cap Carriers' Direct Cases and data submissions.

In their respective Direct Cases, the Price Cap Carriers assert as one that costs attributable to the implementation of SFAS-106 should be recognized as exogenous for purposes of price cap regulation. The carriers essentially make two points in this regard. First, they contend that they have no control over the recognition of the costs incurred in implementing SFAS-106. SFAS-106, they emphasize, has been mandated by the Financial Accounting Standards Board ("FASB") and adopted by the Commission as a mandatory practice for purposes of the Uniform Systems of Accounts ("USOA"). Second, they claim that the vast preponderance of the

cost impacts on local exchange carriers ("LECs") of implementing SFAS-106 will not be captured by the Gross National Product Price Index ("GNP-PI"). In support of this latter contention, the Price Cap Carriers rely principally on a study conducted by Godwins, Inc. ("Godwins") for the United States Telephone Association ("USTA") entitled "Analysis of Impact of FAS-106 Costs on GNP-PI" ("Godwins Report"). In addition, Pacific Bell commissioned and introduced a report prepared by National Economic Research Associates, Inc. ("NERA") entitled "The Treatment of FAS 106 Accounting Changes Under FCC Price Cap Regulation" ("NERA Report").

Recognizing the need for expert analysis of the complicated econometric and other issues specified in the Designation Order, the Ad Hoc Committee retained Economics and Technology, Inc. ("ETI") to analyze the Price Cap Carriers' Direct Cases and the underlying Godwins and NERA Reports. ETI's findings and conclusions are set forth in a report prepared by Page Montgomery and David J. Roddy ("ETI Report") and attached hereto as Appendix I. The ETI Report identifies a series of critical flaws in the Godwins and NERA Reports, as well as in the policy analyses reflected in and the cost support underlying the Price Cap Carriers' Direct Cases. Reflecting those findings, ETI concludes: "Our analysis demonstrates -- overwhelmingly -- that FAS 106 effects should not be treated as an exogenous adjustment under the LEC price cap plan . . . ."<sup>1/</sup>

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<sup>1/</sup> ETI Report at 1.



The Ad Hoc Committee submits that the Price Cap Carriers have not shown, as they must, that the implementation of SFAS-106 will result in exogenous cost changes recognizable under the Commission's price cap rules and policies. Indeed, as will be shown below, exogenous cost treatment of costs arising from this accounting change would conflict with critical elements of incentive regulation. Moreover, given the pervasive flaws therein, neither the Price Cap Carriers' cost studies nor the analyses conducted by Godwins and NERA justify the exogenous cost treatment sought by the carriers or provide a credible basis for computing the PCI adjustments the carriers claim are required to account for costs attributable to the implementation of SFAS-106. The Committee, accordingly, urges the Bureau to reject Bell Atlantic Transmittal No. 497, Pacific Bell Transmittal No. 1579 and US West Transmittal No. 246, and to rule that costs associated with the implementation of SFAS-106 are endogenous and do not require PCI adjustments.

## II.

### ARGUMENT

#### **A. The Price Cap Carriers Have Not Established That The Implementation Of SFAS-106 Will Result In Exogenous Cost Changes Recognizable Under The Commission's Price Cap Rules And Policies**

In a recent decision denying exogenous cost treatment of increases in generally applicable business taxes, the Bureau correctly noted that "[a] fundamental tenet of price cap regulation is that the increased earnings possible under incentive-based regulation yield reasonable rates only to the extent the carrier

experiences increased risk."<sup>2/</sup> Under price cap regulation, "carriers are no longer insulated from every cost change they experience"; generally speaking, price cap carriers must ensure that cost increases do not exceed a "benchmark" adjustment composed of cost changes outside the carriers' control. The benchmark adjustment the Commission incorporated into the LEC price cap plan includes an "inflation measure" -- i.e., the GNP-PI -- which "reflects economy-wide cost changes" and a "productivity offset to the inflation measure" which "reflects the historical productivity of the telephone industry, which has exceeded the productivity of the economy as a whole."<sup>3/</sup> The added risk an LEC accepts in seeking the greater financial rewards price cap regulation allows "flows from the LECs' efforts to beat the benchmark -- i.e., produce cost changes that are lower or less than the benchmark."<sup>4/</sup>

The benchmark, in fairness to both carriers and rate-payers, can be "adjusted upward or downward to account for certain specified cost changes unique to the carrier."<sup>5/</sup> A number of these "exogenous cost changes" are codified in Section 61.45(d) of the Commission's Rules. 47 C.F.R. § 61.45(d). Changes in Generally Accepted Accounting Principles ("GAAP"), such as the adoption of SFAS-106 by FASB, are not included among the presumptively exo-

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<sup>2/</sup> Bell Atlantic Telephone Companies Tariff F.C.C. No. 1, Transmittal No. 473, 7 FCC Rcd. 1486, ¶ 8 (1992).

<sup>3/</sup> Id.; Designation Order, 7 FCC Rcd. 2724 at ¶ 5.

<sup>4/</sup> Bell Atlantic Telephone Companies Tariff F.C.C. No. 1, Transmittal No. 473, 7 FCC Rcd. 1486 at ¶ 8.

<sup>5/</sup> Id. at ¶ 9.

genous cost changes. For that matter, even changes in USOA are deemed to be exogenous only to the extent "the Commission shall permit or require." 47 C.F.R. § 61.45(d)(1)(ii). Indeed, exogenous cost changes (47 C.F.R. § 61.45(d)), including "extraordinary exogenous cost changes" (47 C.F.R. § 61.45(d)(1)(vi)), are subject to this same limitation, as well as "further order of the Commission."

The Commission has discussed on numerous occasions the difficult hurdles LECs must overcome to secure exogenous treatment for costs not presumptively categorized as such in Section 61.45(d). Thus, even though exogenous costs are generically defined as "costs triggered by administrative, legislative or judicial action beyond the control of the carriers,"<sup>6/</sup> the carrier bears the burden of demonstrating that exogenous treatment of any such cost is consistent with the Commission's price cap rules and policies.<sup>7/</sup> And as the Commission has repeatedly emphasized, this burden is a heavy one.<sup>8/</sup>

A carrier must show that an exogenous cost change was specified by Commission or other governmental action and thus

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<sup>6/</sup> See, e.g., Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd. 6786, ¶ 6 (1990) ("LEC Price Cap Order"), mod. on recon., 6 FCC Rcd. 2637 (1991) ("LEC Price Cap Reconsideration Order"), recon. dismissed, FCC 91-344 (Dec. 20, 1991), further mod. on recon., 6 FCC Rcd. 4524 (1991), pet. for rev. docketed, District of Columbia Pub. Serv. Comm'n v. FCC, No. 91-1279 (D.C. Cir. June 14, 1991).

<sup>7/</sup> See, e.g., Designation Order, 7 FCC Rcd. 2724 at ¶ 6; Bell Atlantic Telephone Companies Tariff F.C.C. No. 1, Transmittal No. 473, 7 FCC Rcd. 1486 at ¶ 10.

<sup>8/</sup> See, e.g., Southwestern Bell Telephone Company, Transmittal No. 2051, 7 FCC Rcd. 2906, ¶ 32 (1992).

beyond its control.<sup>9/</sup> The carrier must further demonstrate that it is not able to control or influence the amount or extent of the cost changes purportedly attributable to the governmental action.<sup>10/</sup> Thus, the Commission has found that cost changes attributable to changes in depreciation rates are not properly treated as exogenous because a carrier, through its plant deployment and retirement decisions, essentially controls the rate at which plant investment is translated into depreciation expense.<sup>11/</sup> Treating depreciation expense, or other costs LECs could manipulate, as exogenous, the Commission has recognized, would give the LECs "the power to influence their PCI levels and would destroy the usefulness of the PCI as a benchmark."<sup>12/</sup>

A carrier must also establish that a cost change is unique to or disproportionately effects common carriers to warrant exogenous cost treatment. Costs incurred by the general business population or segments thereof, the Commission has held, are not

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<sup>9/</sup> See, e.g., Policy and Rules Concerning Rates for Dominant Carriers, 6 FCC Rcd. 665, ¶ 63 (1991) ("AT&T Price Cap Reconsideration Order"), pet. for rev. docketed, AT&T v. FCC, No. 91-1178 (D.C. Cir. April 15, 1991).

<sup>10/</sup> See, e.g., American Telephone and Telegraph Company Revisions to Tariff F.C.C. Nos. 1, 2 and 13, Transmittal No. 2304, 5 FCC Rcd. 3680, ¶¶ 5-6 (1990); LEC Price Cap Order, 5 FCC Rcd. 6786 at ¶¶ 182-83.

<sup>11/</sup> See, e.g., Policy and Rules Concerning Rates for Dominant Carriers, 4 FCC Rcd. 2873 ¶ 290 (1989) ("AT&T Price Cap Order"), mod. on recon., 6 FCC Rcd. 665 (1991), pet. for rev. docketed, AT&T v. FCC, No. 91-1178 (D.C. Cir. April 15, 1991); LEC Price Cap Order, 5 FCC Rcd. 6786 at ¶¶ 182-83; LEC Price Cap Reconsideration Order, 6 FCC Rcd. 2637 at ¶ 74.

<sup>12/</sup> LEC Price Cap Reconsideration Order, 6 FCC Rcd. 2637 at ¶ 74.

properly classified as exogenous.<sup>13/</sup> Thus, the Bureau has refused exogenous cost treatment of changes in generally applicable business taxes.<sup>14/</sup> Ancillary to this criteria, it is incumbent on a carrier to demonstrate that the costs asserted to be exogenous are not adequately accounted for in the GNP-PI.<sup>15/</sup> As the Commission has recognized, if a cost change is "universal enough to be reflected in the inflation measure, exogenous cost treatment would result in double counting within the context of the PCI."<sup>16/</sup>

Nor are these threshold standards the only factors that will be considered by the Commission in determining whether a cost claimed by a carrier to be exogenous is indeed so. The Commission has held that cost changes will not be afforded exogenous cost treatment if such action interferes with the orderly administration of its price cap system.<sup>17/</sup> A subset of this concern is the ability of the Commission to police abuses if certain costs are

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<sup>13/</sup> See, e.g., LEC Price Cap Reconsideration Order, 6 FCC Rcd. 2637 at ¶ 69; LEC Price Cap Order, 5 FCC Rcd. 6786 at ¶¶ 176-77; Bell Atlantic Telephone Companies Tariff F.C.C. No. 1, Transmittal No. 473, 7 FCC Rcd. 1486 at ¶¶ 9-10; AT&T Price Cap Reconsideration Order, 6 FCC Rcd. 665 at ¶ 75; AT&T Price Cap Order, 4 FCC Rcd. 2873 at ¶ 272.

<sup>14/</sup> See, e.g., Bell Atlantic Telephone Companies Tariff F.C.C. No. 1, Transmittal No. 473, 7 FCC Rcd. 1486 at ¶ 12; AT&T Price Cap Order, 4 FCC Rcd. 2873 at ¶ 272; LEC Price Cap Reconsideration Order, 6 FCC Rcd. 2637 at ¶ 69.

<sup>15/</sup> See, e.g., Bell Atlantic Telephone Companies Tariff F.C.C. No. 1, Transmittal No. 473, 7 FCC Rcd. 1486 at ¶ 10; AT&T Price Cap Reconsideration Order, 6 FCC Rcd. 665 at ¶ 75; AT&T Price Cap Order, 4 FCC Rcd. 2873 at ¶ 256.

<sup>16/</sup> LEC Price Cap Reconsideration Order, 6 FCC Rcd. 2637 at ¶ 63.

<sup>17/</sup> Id. at ¶ 62.

treated exogenously.<sup>18/</sup> Thus, the Commission has denied exogenous cost treatment of equal access costs because of the potential for carrier manipulation of such costs.<sup>19/</sup>

Exogenous cost treatment of a particular cost must also be consistent with the concept of incentive regulation. Thus, the categorization of a cost as exogenous must not disrupt the delicate balance of risk and reward inherent in the price cap system:

By creating a limited list of exogenous costs, a decision that was heavily debated and thoroughly discussed in the development of price cap rules, price cap regulation creates higher risk for carriers to balance against the higher financial rewards available under the system.<sup>20/</sup>

Moreover, a cost will not be treated as exogenous if to do so would interfere with incentives created by the price cap system for carriers to become more efficient and productive.<sup>21/</sup> Finally, as a logical outgrowth of these policy-oriented concerns, the Commission has held that where price cap policy objectives are implicated, a carrier must demonstrate that, without the adjustment that

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<sup>18/</sup> Id. at ¶ 66; LEC Price Cap Order, 5 FCC Rcd. 6786 at ¶ 180.

<sup>19/</sup> LEC Price Cap Reconsideration Order, 6 FCC Rcd. 2637 at ¶ 66; LEC Price Cap Order, 5 FCC Rcd. 6786 at ¶ 180.

<sup>20/</sup> Southwestern Bell Telephone Company, Transmittal No. 2051, 7 FCC Rcd. 2906 at ¶ 31; see also Bell Atlantic Telephone Companies Tariff F.C.C. No. 1, Transmittal No. 473, 7 FCC Rcd. 1486 at ¶¶ 8-9.

<sup>21/</sup> AT&T Price Cap Order, 4 FCC Rcd. 2873 at ¶ 291.

exogenous cost treatment would allow, a carrier's rates under price cap regulation would be confiscatory.<sup>22/</sup>

It is indisputable that in adopting SFAS-106, the FASB altered the manner in which businesses following GAAP must account for benefits other than pensions provided to retired employees. It is also indisputable that the Bureau found that the adoption of SFAS-106 by the LECs would not conflict with the Commission's regulatory objectives.<sup>23/</sup> And it is indisputable that the Bureau, based on that finding, authorized the Price Cap Carriers to adopt SFAS-106 on or before January 1, 1993 as a mandatory practice for purposes of USOA.<sup>24/</sup> As the Price Cap Carriers have recognized, however, changes in GAAP are not automatically deemed exogenous simply because they are adopted by FASB and approved by the Commission as compatible with its regulatory accounting needs.<sup>25/</sup> The eligibility of changes in GAAP for exogenous cost treatment, the Commission has mandated, is to be considered on a case-by-case basis.<sup>26/</sup>

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<sup>22/</sup> Southwestern Bell Telephone Company, Transmittal No. 2051, 7 FCC Rcd. 2906 at ¶ 32; LEC Price Cap Order, 5 FCC Rcd. 6786 at ¶ 190.

<sup>23/</sup> Southern Bell and GTE Service Corporation, Notification of Intent to Adopt Statement of Financial Accounting Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, 6 FCC Rcd. 7560 (1991) ("SFAS-106 Adoption Order").

<sup>24/</sup> Id.

<sup>25/</sup> AT&T Price Cap Reconsideration Order, 6 FCC Rcd. 665 at ¶¶ 74-75.

<sup>26/</sup> Id.

Carrier claims notwithstanding, the case-by-case consideration of the price cap treatment to be afforded changes in GAAP is not, as discussed above, limited to an analysis of the extent to which costs associated with such changes are adequately reflected in the GNP-PI. Even if double counting was the sole consideration, however, the Price Cap Carriers' efforts to secure exogenous cost treatment of costs attributable to the implementation of SFAS-106 would founder on this element alone. As the ETI Report demonstrates, and as will be discussed in greater detail in a subsequent section of this pleading, the studies upon which the Price Cap Carriers base their claim that SFAS-106-related costs are not adequately reflected in the GNP-PI are so flawed that they provide no credible basis for reaching such a conclusion.<sup>27/</sup> Given that the Price Cap Carriers bear the burden of demonstrating the absence of double counting where exogenous treatment of costs is sought, failure to produce credible evidence on this point is fatal to their efforts to secure exogenous cost treatment of costs associated with the implementation of SFAS-106.<sup>28/</sup>

The Price Cap Carriers' failure to meet their burden of demonstrating that the implementation of SFAS-106 does not result in an exogenous cost change recognizable under the Commission's price cap rules and policies is no less evident when other pertinent factors are considered. For example, the carriers wholly ignore the Commission's concerns regarding a carrier's ability to

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<sup>27/</sup> See pages 19-24, ETI Report at 12-27.

<sup>28/</sup> Bell Atlantic Telephone Companies Tariff F.C.C. No. 1, Transmittal No. 473, 7 FCC Rcd. 1486 at ¶ 11.



influence, or, worse yet, to strategically manipulate, costs categorized as exogenous. As the ETI Report notes, "the FAS 106 accrual process includes very liberal and general provisions accepting many actuarial estimates of future PBOP effects."<sup>29/</sup> Among other things, carriers must project discount rates, returns on plan assets, medical care cost trend rates and data used to compute such demographic factors as retirement, turnover and mortality rates.<sup>30/</sup> In other words, the level of increase in a carrier's PCI that classification of SFAS-106-related costs as exogenous would produce would be determined in large part by unverifiable actuarial and demographic assumptions.<sup>31/</sup>

Could these assumptions be manipulated to inflate PCI levels? Certainly! Indeed, ETI has highlighted dramatic differences among the assumptions reflected in the Price Cap Carriers' submissions here.<sup>32/</sup> As ETI notes, no basis exists upon which the Commission can determine which of these assumptions are correct and which are not; no external benchmarks are available to allow for such a determination.<sup>33/</sup>

Moreover, the obligations estimated under SFAS-106 are not legally binding and do not reflect a carrier's funding obligations. OPEBs may be modified at any time by a carrier; individual

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<sup>29/</sup> ETI Report at 8.

<sup>30/</sup> Id.

<sup>31/</sup> Id. at 2, 8-9, 28.

<sup>32/</sup> Id. at 8, Table A.

<sup>33/</sup> Id. at 2, 8-9, 28.

employees do not have a statutory right to OPEBs.<sup>34/</sup> Employees, particularly those who leave the carrier before retirement, may never receive OPEBs. Thus, PCIs could be inflated to reflect future benefits which are never provided.

The concerns expressed by the Commission in denying exogenous cost treatment of equal access costs are clearly pertinent to this issue:

we believe that . . . the risk that . . . carriers could willfully or inadvertently shift switched access costs into the equal access category argues against exogenous treatment of these costs.<sup>35/</sup>

Similarly, the Commission's determinations with respect to the price cap treatment of increased depreciation expense is illuminating as to this matter:

[a]lthough the Commission prescribes depreciation rates, carriers still exercise control over their depreciation costs with their decisions to deploy or retire equipment . . . treating a change in the depreciation rate as exogenous would give the LECs the power to influence their PCI levels, and would destroy the usefulness of the PCI as a benchmark.<sup>36/</sup>

Exogenous treatment of the costs associated with the implementation of SFAS-106 poses no less of a threat of cost manipulation than would exogenous treatment to equal access costs and depreciation expense. Indeed, denial of exogenous cost treatment of SFAS-106

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<sup>34/</sup> Id. at 9, 12-13.

<sup>35/</sup> LEC Price Cap Order, 5 FCC Rcd. 6786 at ¶ 180; see also LEC Price Cap Reconsideration Order, 6 FCC Rcd. 2637 at ¶ 66 (reference to "the incentives exogenous cost treatment could create to inflate the amounts spent on equal access").

<sup>36/</sup> LEC Price Cap Reconsideration Order, 6 FCC Rcd. 2637 at ¶74.

costs would be fully consistent with the Commission's view that "the price cap index should be devoid of cost indicators over which carriers exercise control."<sup>37/</sup>

The Commission's treatment of equal access costs and depreciation expense is also relevant to other policy-related criteria the Price Cap Carriers must satisfy to justify exogenous cost treatment of SFAS-106 implementation costs. In discussing possible exogenous cost treatment of depreciation expense, the Commission noted that if it were to "guarantee recovery of depreciation expense for carriers, we would risk destroying the very incentives that we wish to create with the price cap program."<sup>38/</sup> In particular, the Commission expressed concern that it might distort carriers' decisions regarding plant deployment.<sup>39/</sup> The Commission expressed similar concerns regarding the impact of exogenous treatment of equal access costs on the efficiency with which carriers would implement equal access.<sup>40/</sup>

Categorizing costs associated with the implementation of SFAS-106 as exogenous could well prove a disincentive to controlling the costs of OPEB and the delivery of those benefits in an efficient manner. Indeed, given that the implementation of SFAS-106 does not require expenditure of current dollars,<sup>41/</sup> a carrier

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<sup>37/</sup> Id. at ¶ 66 n. 77.

<sup>38/</sup> Id. at ¶ 183.

<sup>39/</sup> Id.

<sup>40/</sup> Id. at ¶ 66.

<sup>41/</sup> ETI Report at 12.

would benefit now from proposing "gold-plated" benefits to be provided on some future date. Obviously, such a result is not consistent with price cap objectives.

Exogenous cost treatment of SFAS-106 implementation would also likely require the Commission to resolve numerous disputes regarding the actuarial and demographic assumptions underlying carriers' PCI adjustments. Such disputes would involve the Commission in the very type of costing disputes the substitution of price cap regulation for rate of return regulation was intended to eliminate. Limiting the list of exogenous costs to those costs which are clearly and readily identifiable is consistent with the orderly administration of the Commission's price cap system. The Commission has previously considered its ability to review costs in denying exogenous cost treatment:

we believe that the difficulty of assessing equal access costs . . . argues against exogenous treatment of these costs.<sup>42/</sup>

Of course, any expansion of the list of exogenous cost impacts the delicate balance of risks and rewards upon which the price cap system is built. Each addition to the list incrementally reduces the risks carriers must balance against the higher financial rewards available under the price cap system, as well as the incentives for carriers to manage costs within their control.<sup>43/</sup> Thus, the Commission has approved exogenous cost treatment only when such action is clearly consistent with its price cap rules and

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<sup>42/</sup> LEC Price Cap Order, 5 FCC Rcd. 6786 at ¶ 180.

<sup>43/</sup> Southwestern Bell Telephone Company Transmittal No. 2051, 7 FCC Rcd. 2911 at ¶ 31.

policies, denying such treatment even where it could be arguably justified on one ground or another if it conflicted with a key policy goal. Like equal access costs and depreciation expense, for which some arguments can be made for exogenous cost treatment, costs attributable to the implementation of SFAS-106 could, and should, be denied exogenous cost treatment to ensure that the risks borne by a price cap LEC are adequate to justify the higher financial rewards available under incentive regulation.

Finally, the Price Cap Carriers have not shown that denial of exogenous treatment of the costs associated with the implementation of SFAS-106 would produce rates under price cap regulation that would be confiscatory. Given that the implementation of SFAS-106 would not produce any additional outlays of current dollars,<sup>44/</sup> such a showing would obviously be impossible. Indeed, windfall profits rather than confiscation appears to be a more pressing concern in this circumstance.<sup>45/</sup>

In short, the Price Cap Carriers have simply not made out a compelling case for exogenous cost treatment of costs associated

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<sup>44/</sup> ETI Report at 12.

<sup>45/</sup> As ETI notes, the analyses contained in the Price Cap Carrier Direct Cases ignore offsetting economic effects in seeking to raise PCI levels. For example, ETI points out that "the extent to which PBOP liabilities were reflected in the share prices of the LECs and other firms evaluated by the FCC for the rate of return prescription upon which the LEC price cap plan was based" was not taken into account in these studies. As explained by ETI, "FAS 106 effects already are discounted to some degree in the existing nationwide average rate of return prescribed for all carriers." Moreover, ETI adds, "[t]he LEC submissions also would ignore the interrelationship between employee compensation and benefits including PBOPs, and the savings that would occur through the employee reduction plans now underway." ETI Report at 2, 7-12, 28.

with the implementation of SFAS-106. Not only have the carriers not established that such costs are not adequately reflected in the GNP-PI, but they have not even addressed the myriad other criteria announced by the Commission for inclusion of costs on the limited list of exogenous costs under the price cap regime. Nor could the carriers have justified exogenous cost treatment under these criteria given that categorization of SFAS-related costs as exogenous would run counter to critical price cap policy objectives.<sup>46/</sup> Clearly, the Price Cap Carriers have not carried their burden of demonstrating that implementation of SFAS-106 would result in an exogenous cost change recognizable under the Commission's price cap rules and policies.

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<sup>46/</sup> Southwestern Bell implies, however, that the Commission established a precedent for treating costs associated with the implementation of SFAS-106 as exogenous when it did not require removal of already-accrued OPEB expenses from the initial price cap rates of LECs who had changed their accounting treatment of OPEB expenses before the introduction of price cap regulation. Southwestern Bell Direct Case at 13-14. To the contrary, the Commission made clear that its refusal to "redefine 'reasonable' after the fact did not in any way guarantee that SFAS-106 costs would be treated exogenously following the adoption of the LEC price cap plan"; indeed, the Commission emphasized that exogenous treatment would be afforded such costs only if, among other things, it was persuaded that double counting of costs would not result. LEC Price Cap Reconsideration Order, 6 FCC Rcd. 2637 at ¶ 63. For its part, Rochester argues that the Commission's treatment of the expiration of reserve deficiency amortizations as exogenous compels like treatment of SFAS-106 implementation costs because the only difference between the two items is "the direction of the change." Rochester Direct Case at 16-17. The Ad Hoc Committee disagrees. The amortization program artificially inflated rates to facilitate a transition in the manner in which depreciation expense is calculated; if PCI levels had not been adjusted downward at the end of this program, carriers would have received a windfall. Moreover, as the Commission noted in its AT&T Price Cap Order, "[n]o perverse incentives are created by requiring exogenous cost treatment of these amortizations." 4 FCC Rcd. 2873 at ¶ 292.

**B. The Godwins And NERA Reports Are Fatally Flawed**

As noted at the outset of this pleading, the Ad Hoc Committee retained ETI to analyze the Price Cap Carriers' Direct Cases and the Godwins and NERA Reports on which these presentations are in large part predicated. ETI has identified a serious of what it characterizes as "fatal flaws" in both the Godwins and NERA Reports. The Committee will briefly summarize ETI's findings and conclusions here; a far more thorough and detailed discussion is set forth in the ETI Report attached hereto as Appendix I.

Before addressing the specifics of the ETI critique of the Godwins and NERA Reports, the Ad Hoc Committee wishes to reemphasize a critical point. The Price Cap Carriers bear the burden of demonstrating that costs arising out of the implementation of SFAS-106 are not adequately reflected in the GNP-PI.<sup>47/</sup> To meet such a burden, a carrier must provide credible evidence that no double counting of costs would result if exogenous cost treatment were afforded SFAS-106-related costs. The Price Cap Carriers rely almost exclusively on the Godwins and NERA Reports to support their claim that doubling counting is not a pressing concern in this instance. Therefore, to the extent the Godwins and NERA Reports are shown to be unreliable, the Price Cap Carriers' case fails.

**1. The Godwins Report**

The Godwins Report concludes that 84.8 percent of the costs attributable to the implementation of SFAS-106 are not

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<sup>47/</sup> See, e.g., Bell Atlantic Telephone Companies Tariff F.C.C. No. 1, Transmittal 473, 7 FCC Rcd. 1486 at ¶ 10.

reflected in the GNP-PI. It arrives at this conclusion by combining a "theoretical mathematical model" with "hypothetical data" in an exercise so flawed that ETI has concluded that it is "useless for estimating the effects of SFAS-106 on GNPPI and the LECs."<sup>48/</sup> Indeed, ETI has identified a series of fatal flaws in the Godwins study.

Initially, ETI points out that Godwins employed the wrong kind of model to evaluate the cost effects on LECs of the implementation of SFAS-106. Godwins used a mathematical model designed to investigate concepts qualitatively not quantitatively, rather than an econometric model designed for empirical analysis. As described by ETI, the model selected by Godwins "was never intended to be used to estimate benefit effects and has no track record to determine whether or not the forecasted effects, the underlying assumptions, and the internal relationships have any value." ETI lists a number of proven empirical models exist which could have been adapted for the analysis Godwins was attempting.<sup>49/</sup>

Second, ETI demonstrates that the key numerical parameters in the Godwins model were simply invented, or, to quote ETI, "they were made up." The authors of the Godwins Report appear to realize the need for data. They nonetheless provide no empirical support for their quantitative estimates. Noting that the Godwins Report does not base estimates on actual historical economic data or use macroeconomic data to test whether the model describes the

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<sup>48/</sup> ETI Report at 21.

<sup>49/</sup> Id. at 16-18.



U.S. economy, ETI dismisses the study as a "misled academic exercise."<sup>50/</sup>

Third, ETI shows that the Godwins Model erroneously assumes that employers and workers do not consider the effects of post retirement benefits on real wages. In what ETI characterizes as "an unbelievable leap of faith," Godwins assumes that implementation of SFAS-106 will result in widespread changes in labor hiring because employers will now consider post-retirement benefits to be labor costs. As ETI points out, post-retirement benefits are already "discounted as current and existing labor costs."<sup>51/</sup>

Fourth, ETI notes that the Godwins model incorrectly utilizes an outdated functional form to represent the production function for the economy. The model employed by Godwins was developed in 1928 and, although used until the 1960s, has since been replaced by a series of less restrictive forms. As explained by ETI, the model used by Godwins has been shown to be "far too restrictive to measure changes in the U.S. economy."<sup>52/</sup>

Finally, ETI points out that the Godwins Report "ignores the usual uncertainty that is associated with survey results measured by calculated standard errors." The Godwins Report assumes a standard deviation of zero in utilizing data from surveys. Moreover, the authors provide no information as to variance on the standard deviation of sample data, thereby precluding

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<sup>50/</sup> Id. at 14-15, 18-19.

<sup>51/</sup> Id. at 19-20.

<sup>52/</sup> Id. at 20-21.